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JOSEPH F. KALISH, CHIEF GLOBAL MACRO STRATEGIST

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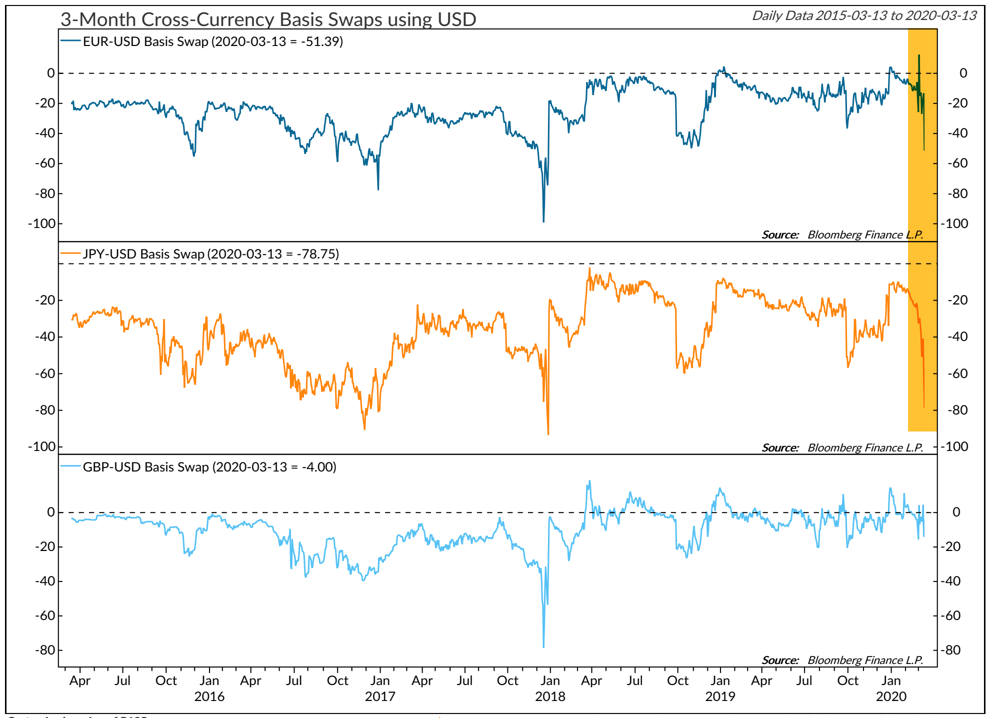
email us

Fed fires bazooka but virus still standing

Key Takeaways

- The Fed's actions should lower yields for both Treasurys and MBS and result in better functioning and liquidity. Lower liquidity swap rates should reduce USD funding strains for developed economies.
- Actions won't narrow credit spreads for corporates, municipalities, or EM.
- The Fed is not out of ammunition but its weapons won't win the war against the virus.

USD funding pressures evident in FX basis swaps



Customized version of B125

The FOMC fired a bazooka Sunday night, issuing updated forward guidance and implementing a new round of large-scale asset purchases. To recap, the FOMC slashed the target range for the fed funds rate by 100 bp back to the zero lower bound (ZLB) of 0.00 to 0.25% for the first time since December 15, 2015. It plans to maintain this range until it is "confident that the economy has weathered recent events and is on track to achieve" its goals.

The Fed will buy $500 billion of Treasury securities and $200 billion of MBS. After buying $37 billion of Treasurys on Friday, it will buy $40 billion more on Monday.

Additionally, the Fed opened the discount window up to 90 days and reduced the rate to 0.25%. It lowered the rate on USD liquidity swap lines to 25 bp over OIS and added an 84-day maturity. The reserve requirement ratio was eliminated. Intraday credit would be provided on both a collateralized and uncollateralized basis. Lastly, banks were encouraged to reduce their capital and liquidity buffers.

What the Fed actions will likely accomplish

It should result in lower yields for both Treasury securities and MBS. We should see an improvement in the liquidity and functioning of these two markets. It will provide modest support for the economy now and more meaningful support for when the economy starts to recover. It should ease overseas dollar funding pressures we saw last week, as shown on the chart.

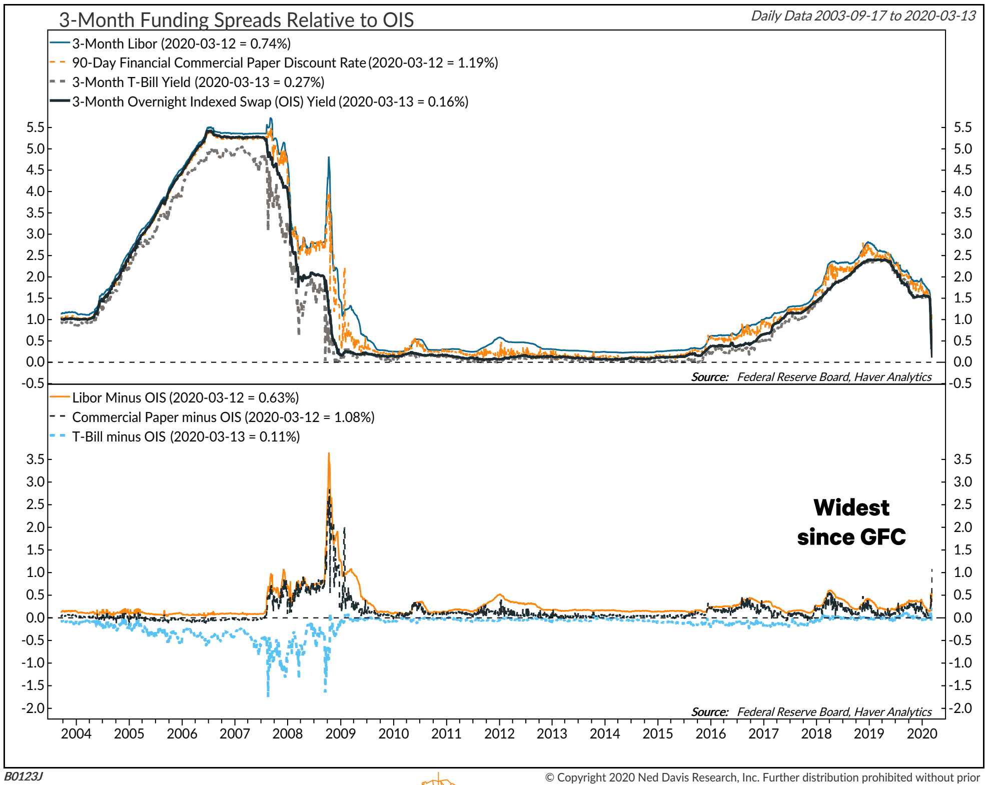
What the actions won't do

It won't compress credit spreads. It won't provide direct support to financially-weakened entities, such as households and SMEs (small and medium enterprises). That's the job of fiscal policy. It won't help the commercial paper market (CP). It won't improve the functioning of the municipal market. While the swap lines help provide dollar liquidity to the major central banks, it doesn't do anything for emerging markets who owe dollar-denominated debt.

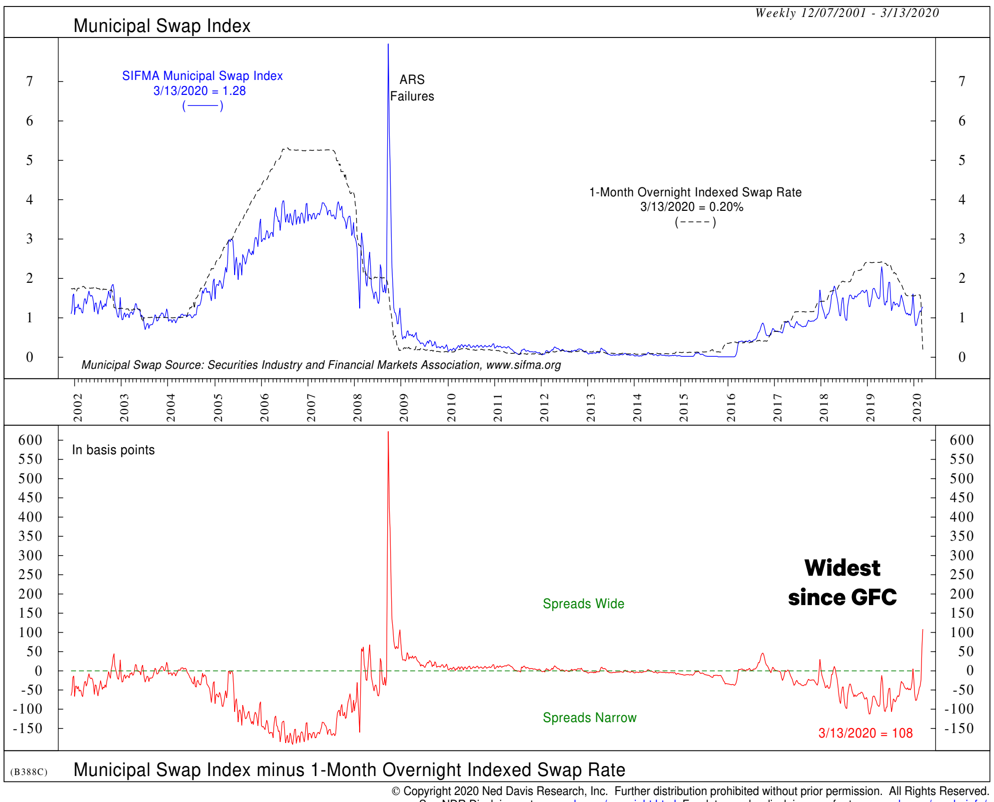
Why they did it

The Fed was unhappy with the liquidity and functioning of the Treasury and agency MBS markets last week. Despite offering huge amounts of liquidity in the repo market, take-up was light. And buying $37 billion of Treasurys didn't prevent yields from rising. If the Treasury market isn't trading correctly, nothing else can either. So job #1 was to fix that market.

Credit stresses building



Liquidity drying up in muni money markets



What else can they do?

Plenty. During the financial crisis of 2008-09 the Fed created numerous facilities, including a Term Auction and a Commercial Paper Funding. Although the Fed is not seeking to reinstate these or similar facilities, it could do so in the future. The Fed is not out of ammunition but its weapons won't win the war against the virus.

Bank and CP funding pressures reminiscent of GFC (top chart). [A2/P2 spreads](#) are blowing out. Municipal funding was failing too (bottom chart).

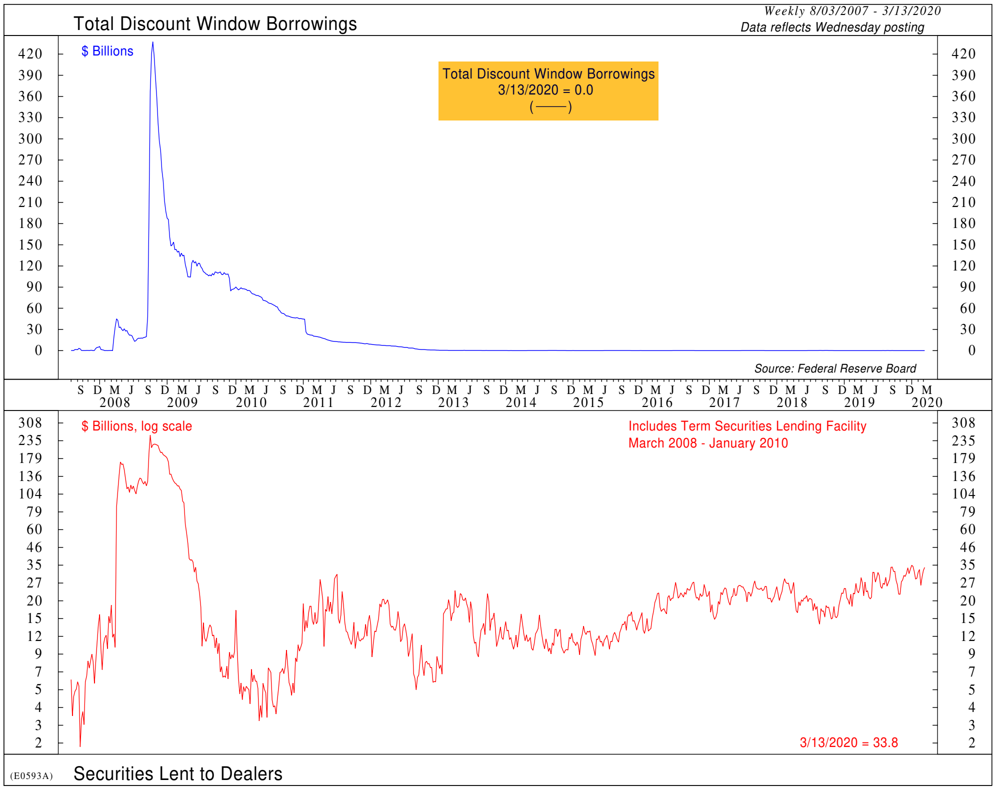
Let's see if anyone borrows from the discount window. Maybe a few small banks will but hard to see how any large banks will use it without violating the HQLA (High Quality Liquid Assets) portfolio and LCR (Liquidity Coverage Ratio) requirements.

Why did Treasury yields rise last week?

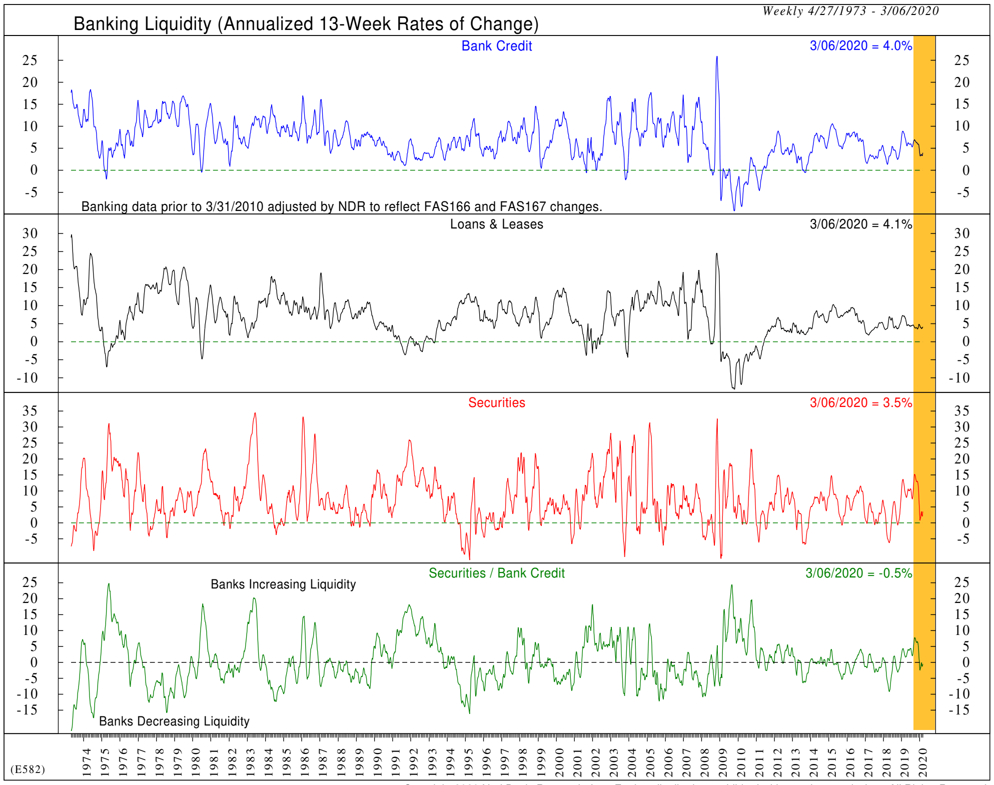
There have been many explanations and there is no single one. My favorites are toward the top.

1. Higher volatility across asset classes raised the value at risk (VaR) at banks, prompting a reduction in all assets and causing dealers to repo their inventory
2. Increased bank lending as companies drew down their credit lines, prompting banks to sell Treasurys and MBS

Nobody has been using the discount window



Banking liquidity has been eroding



3. Higher European yields after the ECB decision pulled Treasury yields up
4. Levered players and funds who saw redemptions needed to raise cash
5. Risk-parity funds sold in response to higher volatility
6. Yields got too stretched/low last Monday
7. Expectations for fiscal stimulus
8. Repatriation back to local markets

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NDR HOUSE VIEWS (Updated March 12, 2020)

NDR recommends an underweight allocation to equities. We are overweight bonds and underweight cash. When coronavirus worries start to subside and global economic activity starts returning to normal, we will likely see stock prices moving higher with rising bond yields. But there's not yet any evidence that such a recovery is at hand.

Equity Allocation

U.S. | We are marketweight the U.S. relative to other regions but negative on an absolute basis. COVID-19 has driven the U.S. into a cyclical bear, but should create a buying opportunity later in the year. We favor large-caps over small-caps and favor Growth over Value.

INTERNATIONAL | We are marketweight all seven regions within our seven-way regional allocation framework.

Macro

ECONOMY | The global economy is in a sustained slowdown. But recession probability for the U.S. remains minimal in the next six to nine months. Major risks include heightened trade war tensions, a sharp slowdown in China, and political dysfunction in the U.S. and Europe.

FIXED INCOME | We are at 110% of benchmark duration. We are neutral on the yield curve. We are underweight credit, MBS, CMBS, and ABS. We are overweight Treasurys.

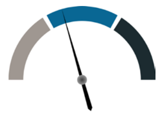
ENERGY | The combination of a demand shock (coronavirus) and an OPEC price war necessitate a bearish oil position.

GOLD | Long-term uptrend intact. We are bullish.

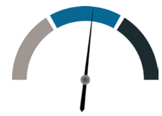
DOLLAR | Our models are mixed.

Economic Summary

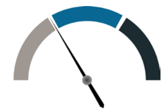
March 16, 2020



Global Economy
Below Trend
(3.3%)



U.S. Economy
At Trend
(1.8%)



U.S. Inflation
Moderate
(2.2%)

● Overweight ● Marketweight ● Underweight

GLOBAL ASSET ALLOCATION

- ● Bonds (45%)
- ●
- ● Stocks (50%) | Cash (5%)

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Equities — Regional Relative Allocation

- ●
- ● U.S. (55%) | Europe ex. U.K. (15%) | Emerging Markets (11%) Japan (7%) | U.K. (5%) | Canada (3%) | Pacific ex. Japan (4%)
- ●

Benchmark – U.S. (55.8%), Europe ex. U.K. (13.7%), Emerging Markets (11.8%), Japan (7.2%), U.K. (4.9%), Pacific ex. Japan (3.6%), Canada (3%)

Global Bond Allocation

- ● U.S. (55%) | U.K. (8%)
- ● Europe (27%)
- ● Japan (10%)

Benchmark: U.S. (51%), Europe (26%), Japan (18%), U.K. (5%)

U.S. ALLOCATION

- ● Bonds (45%) | Large-Cap | Growth
- ● Mid-Cap
- ● Stocks (50%) | Cash (5%) | Small-Cap | Value

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Sectors

- ● Health Care | Consumer Staples
- ● Energy | Industrials | Financials

Those sectors with a benchmark weight > 9%, an overweight/underweight is more than +/- 300 basis points from the S&P 500 benchmark. For smaller sectors, the active bet is +/- 100 basis points.

U.S. Bonds — 110% of Benchmark Duration

NED DAVIS RESEARCH

NDRsales@ndr.com
www.ndr.com
(800) 241-0621

VENICE
600 Bird Bay Drive West
Venice, FL 34285
(941) 412-2300

NEW YORK
1120 Avenue of the Americas
6th Floor
New York, NY 10036
(646) 810-7270

BOSTON
711 Atlantic Ave
6th Floor
Boston, MA 02110
(617) 279-4860

ATLANTA
7000 Central Parkway
Suite 1100
Atlanta, GA 30328
(678) 303-0097

SAN FRANCISCO
50 California Street
Suite 1500
San Francisco, CA 94111
(415) 277-5477

LONDON
8 Bouverie Street
Temple, London
EC4Y 8AX
+44 (0) 20 7779-8682

HONG KONG
38/F Hopewell Centre
183 Queen's Road East
Wanchai
+852 3416 6676

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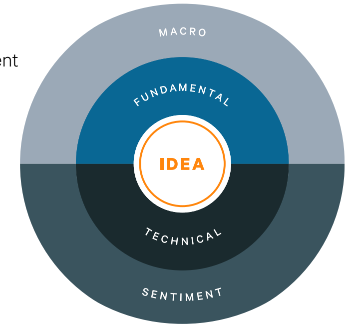

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